Mudher M. Saleh's testimony re: the appreciation of Iraqi Dinar in 2006-8, raises serious questions? By Dr Amer K. Hirmis *

1. Introduction [1]

The purpose of this note is to shed light, and comment, on two views expressed recently in relation to the appreciation of the Iraq Dinar (IQD) in 2006-2008.

Muhammad Tawfiq Alawi (henceforth M. Alawi), former minister of communications in Iraq, gave a talk on December 13, 2019 in Washington D.C. to an Iraqi audience, in which he mentioned the appreciation of the Iraqi Dinar (IQD) during 2006-2008 as an example of lack of economic planning in Iraq. Mudher Muhammad Saleh (henceforth M. Saleh), former deputy governor of the Central Bank of Iraq (CBI), and currently finance advisor to the outgoing prime minister, responded the following day, in an article published at the 'Iraqi Economists Net.'

M. Alawi's and M. Saleh's contributions are respectively available at: https://www.youtube.com/watch?v=xsStEhEWMoc&feature=youtu.be, and, http://iraqieconomists.net/ar/2019/12/19/%d8%af-...(continued)].

These contributions might attract a number of observations from readers. This note, however, focuses on two observations, set out below. First, that the "independence" of the CBI was compromised in negotiating and signing a 'Stand-By Agreement' with the IMF in late 2005. Second, by following the IMF programme in Iraq, the CBI's administration focused its attention on limited instruments of monetary policy as dictated by the IMF, and much less on contributing to national economic growth and leveraging badly needed *major* structural changes in the economy.

2. Summary of the two contributions

In his talk, M. Alawi noted that the appreciation of the IQD in 2007 by 20 per cent was wrong, and that it was seen by "ignorant politicians" to reflect a strong economy, not realising "the damaging impacts this would have on…specifically foreign trade." He also added that he went to see Sinan al-Shibibi, governor of CBI at the time, to tell him, personally, how damaging the appreciation of IQD would be to the economy. Al-Shibibi told him "that he was under pressure from above (i.e. politicians) to do so, and that this decision was imposed on him, and that CBI's responsibility related to monetary policy, controlling inflation, deciding interest rate levels and banking (!); that the politicians point actually related to the wider national economy…I (al-Shibibi) could not do anything...(but to oblige)."

[1] I am very grateful to Dr Barik Schuber, chief IEN editor, for commenting on an earlier draft of this note.

M. Saleh's response falls into three parts; the first covers negotiating the 'Paris Club' agreement, signed on November 21, 2004. Both he and Sinan al-Shibibi were members of the negotiating team, headed by the Finance Minister - Adel Abdul Mahdi (currently the outgoing prime minister). The negotiations led to a reduction of the 'Paris Club' debt (US$ 42.5 bn) by 80 per cent, or US$34.0 bn, [i] implemented in three tranches. [ii] The second 30 per cent reduction was "conditional on signing a 'Stand-By Agreement' (SBA) with IMF." The final tranche, 20 percent reduction, would take effect if "Iraq succeeded in implementing the agreement with IMF by the end of 2008."

M. Saleh then provides the rationale for appreciating the IQD by 31.9 per cent over three years, inclusive; from the end of 2005 to the end of 2008.

He suggests that the "economic model" that the IMF was applying to implement its programme in Iraq required reducing inflation from 20 percent to 6 percent. This scale of reduction required a *nominal anchor* for (Iraqi monetary policy/CBI) to set a path for appreciating IQD by 20 percent, and also to raise the *internal value* of IQD [iii] through raising interest rate by at least 20 per cent. He goes on to say that "the CBI was forced to follow a contractionary (tight) policy to reduce inflation…the Head of the IMF's team made it clear that (the IMF's programme) obliges (Iraq to accept) certain prerequisites; these being amending the internal and external value of the IQD, i.e. interest rate and exchange rate. Al-Shibibi categorically refused such restrictive monetary policy, and left the room, saying 'we will not accept such conditions which curb development.' M. Saleh asked al-Shibibi to return to the meeting because the Head of the IMF team indicated that if (Iraq does not agree the terms) the IMF programme would be stopped, and consequently the 'Paris Club' agreement revoked! M. Saleh (argued) this would result in greater damage (to the economy). "All of us had to accept the increasing IQD's exchange rate, to reach 1,182 for each US$ by the end of 2008, from a base of 1,560 IQD for each US$ at the end of 2005."

M. Saleh concludes that "the problem in my estimation does not only lie in the appreciation of the IQD at the time, in spite of the decline in inflation from 22 percent down to 6 percent (as the IMF required)…but that the major problem (in the economy) remained to be a five times increase in government employment today compared with 2003, and an increase in the government wage bill seven times, which meant that a government employee earns twice the average per capita GDP."

3. Analysis

As the author of this note is not a specialist in monetary policy, the analysis and the evaluation that follows is of general nature.

The analysis is in two parts; the first relates to CBI's "independence", the second is on the lack of material impact monetary policy post-2003 has had on diversifying the Iraq economy (GDP).

The "independence" of CBI

The above account clearly shows that the CBI had yielded to political pressure, leading to the appreciation of the IQD during 2006-8. The appreciation of the IQD by nearly 32 percent, and the increase in interest rate to 20 percent over 2006-8 was, in effect, a decision *made for, not taken by*, the CBI. It is in this sense that the CBI's own administration did, arguably, compromise the Bank's "independence."

Was this a grave decision? Was it a grave mistake? And, was such a major concession to the IMF an opportunity for some members of the CBI administration to resign, as the *guardians* of the CBI's "independence"? That is a judgement for future historian of monetary policy in Iraq, to make.

It is also legitimate to note that the argument used by M. Saleh to persuade al-Shibibi to return to the meeting with IMF is rather tenuous. The present author is hopefully wrong in suggesting that M. Saleh has *not* made the case in his subsequent writings [iv] demonstrating that the damage to the Iraqi economy "would have been greater" than accepting the IMF's conditions.

Another serious question relates to the IMF's condition that the CBI had to *appreciate IQD* (and raise interest rate by at least 20 percent) in tackling *specifically imported inflation*.

To state the obvious, the appreciation of IQD had lowered domestic prices of imports; theoretically, this ought to have a downward effect on inflation. The *extent of the downward effect* would depend on the price of imported goods in the inflation basket of goods and services. Whilst controlling inflation is within the remit of the CBI, the Bank is yet to quantify the *extent of imported inflation* - i.e. provide a justification for linking the appreciation of the IQD and imported inflation in the way M. Saleh has expressed as being *specifically* such a critical monetary policy issue!

That said, it has been suggested that Iraq has been experiencing cost-push/risk-premium inflation post-2003, triggered mainly by domestic factors, including the cost of security, acute shortage of gasoline and fuel products, electricity, transport, corruption (as an economic/financial cost), all of which accumulate in the value chain, and translate to higher market prices of domestic goods and services. [v]

More generally, shouldn't evidence be provided to show whether the CBI's monetary policy of supporting the US$ has succeeded in curbing inflation?

Monetary policy and the wider economy
Arguably, yielding to the IMF's condition that interest rate should be raised to 20 percent during 2006-8 (alongside appreciating the IQD) did not, to say the least, contribute to national economic growth and to leveraging major structural changes in the wider economy. Nor had it attracted notable domestic and foreign private investment in productive sectors, though *only a factor* in decision-making process.

It is fair to say, however, that raising interest rate was not a reaction to market mechanisms; it was an administrative decision by the CBI, as noted by the IMF in its 2006 report (p.8) - "The monetary transmission mechanism…is weak. The effectiveness of interest rate changes in influencing inflation is thus very limited. Economic activity is dominated by cash transactions, and *the banking system is* *largely inert*. Few loans are extended and the deposit base is not very active. *Raising interest rates will nonetheless signal the authorities' determination to deal with inflation*" (see www.imf.org/external/pubs/ft/scr/2006/cr06301.pdf, italics added).

The decision to raise interest rate to 20 percent prompted the minister of planning in 2009, Ali Baban, to express his deep concerns about how disconnected monetary policy was from the real economy. Baban observed that the CBI's policy of controlling inflation (as its central target) by raising interest rate so high was misguided and choking private investment possibilities. [vi] Adding his voice in 2011, Ahmed Braihi Ali (currently on the CBI's Board of Directors) noted that "targeting inflation may be consistent with intervention in the exchange market to prop up the IQD's exchange value, but a dearer IQD in the trade market may also be harmful to non-oil Iraqi exports, job creation, attempts to ameliorate the structural problems, and, thus economic growth more generally." Ali continued "…cheaper imports (if dumping), might lead to the closure of many SMEs in the country as they would not be able to compete with cheaper imports. It is important that the CBI strikes the right balance between its responsibility for monetary policy and its (direct or indirect) responsibility for the wider economy" (brackets added). [vii]

The views against raising interest rates and the damaging practices of (practically unregulated) commercial banks is shared by Iraqi industrialists, for example, Jamal Muhsin [viii] and Mahdi al-Banaī [ix] who suggested that the "the CBI has contributed to the demise of the industrial and agricultural domestic production through "auction" of foreign currency and the US$ generally…It has more to do with the CBI selling its reserves…to the importers and the (domestic) banks, only to continue the haemorrhage (of foreign reserves) and the rise of domestic production costs, to the point where firms cease to compete with imported goods that are supported by the countries of origin, floating their currencies, and ensuring that Iraqi-produced goods become less cost-competitive." They also raise the issue of the near impossible conditions the private commercial banks apply to investors seeking credit (*cf.* end note **iv**).

It is fair to say that these issues are of critical importance in terms of the impacts of the CBI's monetary policy on the Iraq economy post-2003. A more balanced testimony by M. Saleh might have detailed the negative impacts on CBI's monetary policy on the wider economy.

4. Evaluation

Although M. Saleh concludes rather fleetingly that the problem in his estimation did not only lie in the appreciation of the IQD at the time...but that the *major* problem remained to be a five times increase in government employment today etc. it would have been right to state albeit briefly the damages the CBI's monetary policy, *inter alia*, caused the Iraqi economy, post-2003. Given that M. Saleh has access to up-to-date relevant data, there would have been merit in assessing the lack of progress in restructuring of Iraqi GDP resulting from the monetary policy followed by CBI under the influence of the IMF.

Perhaps it is also legitimate to ask whether a monetary policy supporting economic diversification, and tighter regulation of the commercial banks and the currency auction, might have resulted in much less than five times increase in government (public sector) employment, and its damaging fiscal consequences, denying more funds for investment in productive sectors of the economy, infrastructure and the defragmentation of the allegedly corrupt institutions.

Blaming fiscal policies for the unnecessarily large size of government might be interpreted as an attempt to exonerate the CBI from its mistaken monetary policies post-2003! The reality is that monetary and fiscal policies have been operating in diametrically opposite directions; respectively contractionary *versus* expansionary policies since 2003!

Instead, M. Saleh appears to embrace the IMF programme in Iraq, and the Fund's economic arguments, at least in terms of adopting a liberal exchange rate and trade liberalisation (much in line the 'Washington Consensus'), eliminating quantitative restrictions, providing trade protection and virtually minimum (if any) tariffs. The CBI designed the so called 'currency auction' which, as is widely recognised, has become a mechanism for laundering money and supporting what M. Saleh calls the 'liberal financial capitalism' in Iraq.

When asked, in an interview in March 2019, to elaborate on "major economic reforms" in Iraq, including comprehensive restructuring of the economy and rumours of "unfettered" privatisation of public assets along the "prescriptions of the IMF and their known conditions", M. Saleh clearly evaded the question. Instead he spoke about "partnership (between the public and private sectors) in the first instance and, secondly, 'secured privatisation'…" [x]

Finally, apart from the erroneous figures mentioned in M. Saleh's 'testimony' and the misleading statements, [xi] his intervention might correctly be read as another attempt to defend CBI monetary post-2003. His 'testimony', could, and should have provided a balanced account by elaborating on the damages caused by contractionary CBI's monetary policies, in line with IMF's condition, for which the administration of the Bank ought to take responsibility (it is fair to say).

5. Conclusion

It is a welcome initiative that a senior advisor to the (outgoing) Iraqi prime minister should take the time to "clarify" the "economic" arguments and politics that led to the appreciation of the IQD during 2006-2008.

However, the above analysis clearly shows that M. Saleh did not provide the readers with a balanced account; he did not touch on the negative consequences of these decisions on the wider economy, for which the CBI should take responsibility - i.e. not contributing to the restructuring the Iraqi economy (GDP), or supporting the private sector to invest in productive sectors. It is a fact that the contribution of productive sectors to GDP has actually diminished since 2003. Suffice it to mention that manufacturing contribution to *non-oil* GDP (1988 prices) has declined from 4.4 percent in 2004, to 3.5 percent in 2014, then to a mere 1.9 percent in 2019 (first three quarters). [xii]

Notes:

[i] *Cf.* Ashley Seager, 2004, *US persuades Paris Club to write off £23bn of Iraqi debt* (posted at reduce **https://www.theguardian.com/business/2004/nov/22/iraq.debt,** accessed July 10, 2010). Ashley notes that the deal with the 'Paris Club' would cancel 80% of the debt, which amounted to about US$42bn (£23bn); Paris Club deal is seen as central to get the Iraqi economy back on its feet.

[ii] "Iraq's external debt comprised four components: Paris Club bilateral debt ($42.5 billion), non-Paris Club bilateral debt ($67.4 billion), commercial debt ($20 billion) and multilateral debt ($0.5billion). Debt relief negotiations first led to an 80% reduction of the Paris Club debt. The Paris Club agreement also set the terms for non-Paris Club and commercial debt cancellation levels" [see Martin A. Weiss (2011) *Iraq's Debt Relief: Procedure and Potential Implications for International Debt Relief* , available at: https://fas.org/sgp/crs/mideast/RL33376.pdf, accessed on Jan. 10, 2020]. The above figures suggest that Iraq's external debt, immediately post-2003, was estimated to be US$130.4 billion. "Reducing this debt to a sustainable level has been a priority of the U.S. government… Negotiations with non-Paris Club bilateral creditors including Saudi Arabia and other Persian Gulf countries are ongoing. The United States forgave its Saddam-era debt, worth $4.1 billion, in November 2004" (*ibid*).

[iii] In theory, the internal value of money is the value of money when buying goods and services. This is the real value of money and it is measured by the purchasing power of money. The external value of money is what the currency is worth, as measured in foreign currency. This is the exchange rate.

[iv] A list of Mudher M. Saleh relevant writings (in Arabic) is posted at CBI's website, see https://www.cbi.iq/page/37. The most relevant paper to this note is his July 2008 paper entitled '*Monetary policy of the CBI and the need for economic growth and stability*' (see https://cbi.iq/static/uploads/up/file-152223338434531.pdf), in which he notes (p. 16) that "many banks have taken the opportunity in invest their surpluses, in some cases 100 percent, in the CBI's instruments, making profit, rather than be concerned with economic activity…" However, the present author is not aware of M. Saleh having answered the question posed above relating the balance between the alleged damage to the Iraqi economy and the abandonment of the SBA with IMF, and would be happy to be informed otherwise.

[v] See for example the recent paper by Amir al-Athath, 2018, *Analysis and critique of monetary policy in Iraq* (available at http://iraqieconomists.net/ar, accessed July 9, 2018). Also, see the IMF's 2006 Iraq -country report, which stated "The factors driving inflation have been changing over the past two years…but the ongoing insurgency, and the resulting acute shortages of certain goods (especially gasoline and other fuel products), continues to play a major role" (https://www.imf.org/external/pubs/ft/scr/2006/cr06301.pdf).

[vi] Baban, Ali (2009) *Monetary and Economic Policies in Iraq…What Connection?* (al-Awqat al-Iraqiyyah, a weekly economics magazine published by the Ministry of Planning, available at: http://www.iraqitimesmg.com/subgest/weekeconomic.htm. Accessed on April 19, 2009).

[vii] Ali, A. Braihi (2011b*) Inflation viewed from the perspective of the real economy variables versus monetary analysis* (posted on www.iier.org, accessed on December 14, 2012, in Arabic).

[viii] Jameel Muhsin, 2019, *The concept of the private sector in Iraq – what reform do Iraqi demand from an authority that is the core of the problem?* (available at: http://assafirarabi.com/ar/25177/2019/04/11/ (to be completed).

[ix] Mahdi al-Banaī, Chairman of 'Advanced Food Industries' company, as quoted by Amir al-Athath (*op cit*: 7). Al- Banī 's article was published at http://iraqieconomists.net/ar/, on March 21st, 2013.

[x] Al-Thaqafa al-Jadida, 2019, *al-Thaqafa al-Jadida Talks to Dr. Mudher M. Saleh* (March 2019 issue 4040-405, pages 128-146. The question relating to IMF and M. Saleh's answer appears on pp. 143-46).

[xi] In his 'Testimony', M. Saleh mentions that "the 'Paris Club' agreement signed on November 21, 2004 reduced 80 percent of gross Iraq debts…estimated at US$ 128 billion…" This statement could easily be mistaken to mean that the agreement reduced 80 percent of US$ 128 billion, and that this amount included all foreign as well as domestic debt. This is incorrect. The 'Paris Club' bilateral debt actually amounted to US$ 42.5 billion, and the 80 percent reduction amounted to US$34.0 billion. Also, not mentioned in M. Saleh's testimony is that the 80 percent reduction was to be made in net present value (NPV) terms. As shown in Note ii above, Iraq's external debt, immediately post-2003, was estimated to be US$130.4 billion (not US$ 128 billion) of which the 'Paris Club' comprised US$ 42.5 billion.

[xii] Central statistical organisation (CSO) - Iraq, and author's calculations; for 2019 figures, see CSO, 2019, *Preliminary estimates of GDP for the first three quarters* (http://cosit.gov.iq/documents/national_accounts/national_income/reports/gdp...%202019.pdf).

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